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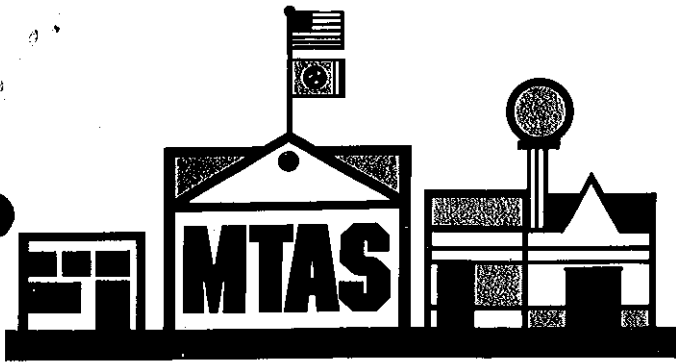
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TECHNICAL BULLETIN

MUNICIPAL TECHNICAL ADVISORY SERVICE
THE UNIVERSITY OF TENNESSEE
IN COOPERATION WITH THE TENNESSEE MUNICIPAL LEAGUE

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August 5, 1982

TERMINATION OF SOCIAL SECURITY COVERAGE FOR MUNICIPAL EMPLOYEES*

by

Dennis W. Huffer, MTAS Legal Consultant

Recently there has been growing interest among local governments in withdrawing from the social security system. This interest has been stimulated by several factors: The rising costs of the social security program have prompted many local government employers to look to withdrawal as a way to reduce operating costs. Many older employees, having become permanently insured for retirement benefits, can increase their retirement income by ceasing to pay social security taxes and investing those funds elsewhere. And, finally, there is a general perception, particularly among younger workers, that the system will not be able to pay benefits when they retire.

The purpose of this bulletin is to review, in a general way, the pros and cons of withdrawal from the system and to outline the steps to be taken to initiate withdrawal. Any final decision about withdrawal should be made only after a complete actuarial study of the effects of withdrawal on the city as well as on its employees. Since each city's situation is different, a blanket recommendation cannot be made regarding withdrawal. Certain general advantages and disadvantages of withdrawal, however, should be taken into consideration.

Advantages of Withdrawal

(1) Increase in take-home pay and increased flexibility in retirement planning. The most noticeable and immediate advantage of withdrawal for workers is the increase in take-home pay. This advantage, however, has to be weighed against what can be purchased to replace social security coverage through a private plan. Although it is probably not possible to match social security coverage in the private market, withdrawal would

*Much of the information in this bulletin came from a report, dated May 21, 1982, entitled "Termination of Social Security Coverage for Employees of State and Local Governments and Nonprofit Groups," which was prepared by the staff of the Committee on Ways and Means of the U.S. House of Representatives.

allow workers, especially younger ones, greater flexibility in providing against only what they consider the most likely eventualities, such as retirement. Other benefits provided through the social security system, such as medicare (if the employee has worked in covered employment less than 10 years) and disability benefits, would either be lost or would have to be replaced through a private plan.

(2) Windfall for older workers. An advantage of withdrawal for older workers is the windfall those would receive upon retirement who had worked in covered employment long enough to receive a retirement benefit even if they stop paying social security taxes. This windfall for workers with less than a full career in covered employment results from the social security benefit formula, which does not distinguish between workers with low earnings and workers with only the minimal amount of covered employment. Because of social security's progressive benefit structure, low wage earners generally receive a higher return on their contributions than high usage earners. But because the benefit formula does not distinguish between the career-long low wage earner and the high wage earner only part of whose career is covered, the high wage earner will receive a windfall upon retirement. Of course a low wage earner only part of whose career is covered would also receive such a windfall, but not to the same degree.

(3) Entitlement to medicare. Another advantage for workers with careers only partially covered by social security is entitlement to medicare. A worker becomes entitled to medicare after 10 years of covered earnings. Since the amount of medicare benefits is not limited by the employee's earning record, even minimal covered earnings will qualify a worker for full benefits.

(4) Spouse benefits. An advantage of withdrawal from the social security system for many women, and some men, is that many people who are married to higher-earning spouses in the covered work force are able to see their coverage terminated with no decrease in their retirement income. Under social security dual entitlement rules, although a worker may not receive a full worker's benefit and a full spouse benefit, in effect, the spouse receives the higher of the two. Thus a spouse of a higher-earning person could terminate his or her coverage and receive the same retirement income based upon the earnings of the higher-income person.

(5) Savings for municipal employers. For employers, the only real advantage in withdrawing from the social security system is the substantial savings that might be realized, depending on how much of social security coverage they attempt to replace. The closer a replacement plan comes to matching social security's protection, the more expensive it becomes. And even though substantial savings can be realized, an employer's withdrawal poses risks to employees' pension and insurance protection.

It should be noted that for each of the seemingly unfair advantages listed in items (1) through (4) above in which certain groups profit at the expense of the system, legislation has been enacted or is pending that would either partially or totally eliminate the advantage. Legislation passed in 1977 will eliminate the advantage of the social security spouse

benefit for state and local government workers at the end of this year unless proposals to delay its effective date are enacted before then. The windfall arising from the weighted benefit formula would be eliminated by legislation which has been approved by the Social Security Subcommittee of the House Ways and Means Committee. The President, in his fiscal 1983 budget proposals to Congress, advocated requiring federal employees to pay the medicare portion of the social security tax. Thus, when unfairness crops up in the system, Congress and the executive branch have shown a willingness to address and correct it. The only general advantages for workers listed here, therefore, which are assured of any longevity are the increase in take-home pay, which may in the long run prove to be not so advantageous, and increased flexibility in retirement planning.

Disadvantages of Withdrawal

Many of the benefits provided by the social security system derive from the fact that it is an almost universal government-sponsored social insurance system. Major effects of withdrawal from the system on workers include loss of specific social security features that are difficult to replace, the creation of gaps in the employee's earnings record, and the possible loss of all pension protection because of varying vesting requirements and the limited portability of state, local, and private plans.

(1) Universality and safety of the system. Perhaps the main advantage of the social security system, and thus the main reason for the disadvantages of withdrawal, is that it is an almost universal social insurance system. Its near-universality allows the system to provide benefits which are almost impossible in any more limited scheme. There are generally no problems with portability, and the system is guaranteed through the political process to pay benefits. Since the social security system is part of the political process, it can reasonably be expected to continue in existence in a form acceptable to most voters. Private risk-taking investments are in most cases a great deal more risky.

(2) Benefits difficult to replace by other plans. Special features of social security which apply to almost all beneficiaries and which are extremely difficult to replace by other plans include:

- (a) Tax-free status of benefits.
- (b) Indexing of initial benefit levels to increase in average wages, even if the beneficiary leaves the system before peak earning capacity.
- (c) Indexing of current benefits to the cost of living.
- (d) Medicare.

Also, the social security benefit formula allows for some increase in benefits to those who suffer unemployment or employment at very low wages by the deletion of up to five years of low earnings. And, typically, private plans cannot duplicate social security survivor benefits.

(3) Gaps in and/or loss of coverage. Gaps in social security coverage are also caused by withdrawal. Workers whose coverage is withdrawn before they become fully insured and who never again work in covered employment will realize no benefit based on FICA contributions they had already made. Employees, especially older ones, should also realize that terminating their coverage substantially before retirement will lower their retirement benefits. Also, even if a worker is fully insured for retirement benefits, disability coverage is lost five years after withdrawal.

(4) Lack of portability of other plans. A similar problem for workers is that private pension plan coverage generally is not portable. Because of this lack of portability and the varying vesting requirements of private plans, a worker could easily move from one noncovered job to another and never acquire any pension protection or social security coverage. This would be an acute problem for an average or low wage earner who had little or no savings and for many women who may have substantial periods of no covered earnings because of child rearing.

(5) Increasing strain on system. Withdrawing from the system means the social security trust funds will have less money with which to meet their obligations. If all organizations which now have termination notices pending go ahead and terminate, the trust funds will lose about \$500 million each year. This burden will have to be borne by those who are still in the system. Those who are still in the system and who must pay the taxes will undoubtedly view voluntary participation for local governments as unfair. This could lead to greater efforts to make coverage for local governments mandatory.

(6) Termination is forever. It should also be noted as a disadvantage of withdrawal that once coverage is terminated for a coverage group such as a municipality it cannot under present law be reinstated.

Procedure for Withdrawal

A municipality which has had social security coverage for its employees for at least five (5) years may request withdrawal from the system by going through the following procedure:

(1) The governing body must adopt a resolution authorizing the coverage group to seek termination and authorizing the mayor to file a termination request. There is a sample resolution attached to this bulletin.

(2) The mayor must file the request by sending a letter giving notice of the municipality's desire to terminate coverage, along with a certified copy of the resolution authorizing it, to:

Mary E. Smith, Director
Old Age and Survivors Insurance Agency
1217 Andrew Jackson State Office Building
Nashville, Tennessee 37219

The resolution and letter requesting termination should indicate that the coverage group understands that once social security is terminated, it can never be reestablished. There is also a sample letter attached to this bulletin.

(3) The municipality must provide the state agency with an alphabetical list of the names and mailing addresses of all covered employees. The list should be in suitable form for use as a mailing list for notification purposes.

After these steps are completed, the state agency will request the Social Security Administration to terminate the municipality's coverage. Termination cannot take effect until two (2) years from the end of the

calendar year in which the termination request is submitted. Therefore, any termination request submitted in this calendar year would not take effect until December 31, 1984.

Any municipality which is seriously considering withdrawing should probably proceed with the three steps outlined above. A termination request can be withdrawn any time before it goes into effect. The at least two-year interval between the submission and the effective date of the request, along with the fact that the request can be withdrawn, provides the municipality with a good opportunity and a sufficient amount of time to study the effects of withdrawal. During this two-year period the municipality should have an actuarial study done on the effects of withdrawal. People from the Social Security Administration are also available to discuss the ramifications of withdrawal. Their services may be obtained by contacting Mary E. Smith of the Old Age and Survivors Insurance Agency at the address given above. If it turns out that the municipality, after weighing all factors, decides not to withdraw, the request for termination can be withdrawn by the adoption of a resolution by the governing body requesting that the state agency contact the Social Security Administration and withdraw the municipality's request for termination. If the municipality decides to withdraw, sometime near the end of the two-year waiting period any ordinances authorizing social security coverage should be repealed effective on the termination date.

Afterword

It should be noted at this point that the entire foregoing discussion could be rendered moot by legislation which is pending in Congress. H. R. 3207, known as the "Pickle bill" because it is sponsored by J. J. Pickle, the Chairman of the House Subcommittee on Social Security, would eliminate the option to terminate coverage for state and local governments. This bill would also render void any termination notice filed after March 25, 1981. Although this bill would be open to constitutional challenge as requiring state and local governments to pay federal taxes, if it were adopted and upheld, it would eliminate the option of withdrawal for all local governments except those who got in their termination notices before March 25, 1981.

Congress might also begin to look at less drastic alternatives than the "Pickle bill" in regulating terminations. Alternatives that might appear attractive in Congress include requiring notification of employees that the employer intends to file a termination notice, requiring a referendum of employees on the subject of withdrawal prior to filing a withdrawal notice, and requiring the employer to provide a substitute pension plan with substantially the same benefits as social security. In light of increased termination requests, it is likely some restrictions on terminations will be enacted in the near future.

SAMPLE RESOLUTION

RESOLUTION NO. _____

A RESOLUTION directing the Mayor of the _____ of _____ to request termination of social security coverage for employees of the municipality.

WHEREAS the Social Security Act provides that local governments which have had social security coverage for their employees for at least five (5) years may seek to terminate such coverage; and

WHEREAS the _____ of _____ has had such coverage for its employees for five (5) years or more; and

WHEREAS the governing body of this municipality deems it in the best interest of the municipality to seek to terminate such coverage, now, therefore:

BE IT RESOLVED BY THE _____ of the _____ of _____ AS FOLLOWS:

Section 1. The Mayor is hereby directed to send a letter seeking termination of social security coverage for the municipality's employees to the State Old Age and Survivors Insurance Agency.

Section 2. It is further directed that an alphabetical list of the names and mailing addresses of all the municipality's covered employees be made to be sent with the termination letter.

Section 3. The municipality understands that once it terminates social security coverage, it can never be reestablished for the municipality's employees.

Section 4. This resolution shall take effect upon its passage, the public welfare requiring it.

Passed this _____ day of _____, 19__.

Mayor

The foregoing is certified to be a true and correct copy of the resolution requesting termination of social security coverage for the municipality's employees adopted the _____ day of _____, 19__.

Recorder or City Clerk

SAMPLE LETTER

Ms. Mary E. Smith, Director
Old Age and Survivors Insurance Agency
1217 Andrew Jackson State Office Building
Nashville, Tennessee 37219

Dear Ms. Smith:

As Mayor of the _____ of _____, I hereby request termination of social security coverage for employees of this municipality. Enclosed are a certified copy of the resolution authorizing this letter and an alphabetical list of the names and mailing addresses of covered employees of the municipality.

Social security coverage has been in effect for employees of this municipality for at least five (5) years. The municipality understands that once it terminates social security coverage, such coverage can never be reestablished.

If you need further information, please let me know. A written acknowledgement of this letter would be appreciated.

Very truly yours,

Mayor

Enclosures:

1. Resolution
2. List of employees

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